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Financial Risk Management from an Islamic Perspective: The case of CPO Futures

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ABSTRACT

The globalized financial system and the internationalization of trade have given rise to a new typology of risks that negatively impact companies. Thus, hedging strategies and instruments (derivatives) have been proposed to mitigate these risks. Indeed, conventional finance does offer a large choice of instruments to cover against financial risks but based on risk shifting. Oppositely, Islamic finance must push its financial innovation wheel to offer better hedging instruments based on risk-sharing. Despite the existence of many Islamic hedging instruments, shari'ah consensus is a way ahead to reach. Hence, this paper will try in the first place to present these hedging instruments proposed so far then a case study of shari'ah issues surrounding Crude Palm Oil (CPO) Futures will examined to highlight the key divergences of hedging in Islamic finance.

Key words: Derivatives, Hedging, CPO futures, financial innovation.

INTRODUCTION

The impressive growth track of Islamic banking over the last few years has created high expectations in the stake-holders and has compelled the major players of the banking industry, investors as well as regulators and government to view it as a separate segment in the banking industry. In addition to that, we count more than 700 Islamic Financial Institutions are operating across the globe with around US$1.2 trillion[2] assets under management in more than 85 countries essentially the nine core markets (Bahrain, Qatar, Indonesia, Saudi Arabia, Malaysia, United Arab Emirates, Turkey, Kuwait and Pakistan). Together, they account for 93% of industry assets, estimated to exceed US$920 billion[3] in 2015. Financial Institutions from Middle East, Far East, US and Europe to Africa, South and Central Asian republics are offering Islamic banking services. The industry is growing at a rate of roughly 15-20[4] percent per year, and could serve 40 to 50 percent of the world's Muslim population within a decade. According to a recent estimate by Standards & Poors the market potential for Islamic banks is estimated at $ 4 trillion.
As hedging provides protection for economic agents, it would not seem surprising that it should fall into one Maqasid Al-shari'ah which is the preservation of wealth. Hence, Islamic finance offers various instruments for hedging purposes as the complexity of international markets give rise to new typology of risk. Obaidullah (2005) rightly notes, "The provision of hedging facility is hardly an adequate rationale for tolerating *Qimar* and *Maysir*. The Shari'ah does not disapprove of hedging, since it brings in some It is the zero-sum nature of the game that the Shari'ah finds objectionable, as in it lie the roots of social disharmony and discord." Thus, the necessity of hedging is crucial to protect the wealth as it falls into Maqasid Al-shari'ah. However, conventional instruments, mainly derivatives, cannot separate hedging from speculation.

This paper is presented as an attempt to show that Islamic finance does provide solution for financial risk management unlike the ongoing thinking. It will present in the first chapter the framework of risk management in Islamic finance, then a brief presentation of the main shari'ah-complaint hedging instruments and finally it will be question of examinating with much detail Crude Palm Oil Futures (CPOF) and the main problematic that retains a global shari'ah consensus on them.

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[2] Ahmed Ali Siddiqui, Executive Vice President, Product Development & Shariah Compliance, Meezan Bank Limited
[3] World Islamic Banking Competitiveness Report 2016
[4] fourth edition of the Islamic Financial Services Board's (IFSB) Islamic Financial Services Industry Stability Report

I. FINANCIAL RISK MANAGEMENT IN ISLAMIC FINANCE:

The necessity to take risk is in the core of value creation in any nation. In fact, on one hand experts and specialists agree that no economic growth can take place without taking risks. "Nothing ventured nothing gained" is the first principle of investment. (Al-Suwailem, 2006). Hence, Islam put risk in the core of its concern by emphasizing and insisting on equity-based financing to simulate growth and prosperity.

Muslim jurists use both *khatar* (Risk) and *mukhatarah (*Risk taking) for business risk. Mukhatarah is defined as "possibility of unexpected outcomes" (Al-Sharbasi, 1981). From this definition, we can say that a distinction must be operated on the nature of risk. Business risk as defined above is an inseparable element of any transaction. More than that, business risk is the legitimate reason from which one can claim to any profit. Indeed, under the rules of shari'ah, return is directly linked to the exposure of an ex ante investment risks according to the fiqhi rule *"al-ghounmu bil al-ghourm"*. Also, returns assume liability "*Al-kharaju bi Daman"* meaning that any profit occurs after a liability.

Hence, the typology of risk as stated by Ibn Taymiah (728H – 1328G) falls into two categories: commercial risk, where one would buy a commodity in order to sell it for profit, and rely on Allah for that. This risk is necessary for merchants, and although the probability of loss exists, but this is the nature of commerce. The other type of risk is that of gambling, which implies eating wealth for nothing. This is what Allah and his Messenger (peace be upon him) have prohibited. As risk manager, the process of risk mitigation would only occurs on the second type of risk which is exogenous to the transaction. As example, exchange rate risk falls into this category as most of its fluctuation happens under excessive speculation and financial decisions that do not concern the commercial transactions. Exposing wealth to loss cannot be a goal in itself. In fact, al-Qarafi clearly states that i.e. protection of wealth, is desirable for rational agents (Al-Suwailem, 2006). it can be clearly seen that hedging is encourage in Islam but despite the fact that the majority of Shari'ah standard-setting authorities agree on the need of hedging, divergences still remain concerning the legality and Shari'ah compliance of certain Islamic hedging instruments. In fact, Dallah Al-Baraka (2002) in its Resolution 6/27 describes the practice of hedging as "an agreement where parties agreed to enter into a contract in the future for the protection of the buyer and seller as a safeguard against fluctuations of the market rates". Bases on this definition, we can say that the definition of hedging in Islamic finance is quiet similar to its definition in conventional finance which implies the existence of a general consensus among shari'ah scholars to the necessity of hedging.

However, the question that arises is on which ground the practical framework of Islamic hedging instruments should come from. The reason to ask this question is that current hedging instruments in conventional finance mainly "derivatives" are based on a model of risk transfer that creates more risk in the system. In the case of risk transfer and shifting model, risk is commoditize through its separation from the original transaction. This process of commoditization of risk leads to its proliferation in the system. The normal result of this situation is more instability and therefore, more recurrent crisis.

Consequently to that, Muslim scholars have created a new category of tolerated risk which shall be hedge against it. It is mainly based on risk sharing or, technically speaking, on a zero-sum game where the outcomes benefit to both counterparties and the element of excessive *gharar* is neutralized.

II. SHARI'AH-COMPLIANT HEDGING INSTRUMENTS:

Andreas Alexander Jobst (an economist at the International Monetary Fund) aids its comment on the possibility of structuring derivative within an Islamic finance environment that "derivatives must also be employed without risk of exploitation in a bid to create an equitable system of distributive justice in consideration of the public interest (maslahah)."[5] Thus, the only technical constraint in addition to those related to shari'ah principals is the application of the risk-sharing principle as a basis for all coming products.

The solutions proposed by Islamic finance are inspired from the conventional instruments (Options, Forwards, Futures & SWAPs). It is arguable that this process might produce questionable instruments as their basis is the main reason why this process started in the first place. However, the willingness to push and develop Islamic finance to offer relative accepted instruments can tolerate it. Also, most of Muslim countries are raw-materials exporting countries which exposes them to the fluctuations of exchange rates. Thus, shari'ah-compliant hedging instruments are very crucial to their day-to-day operations. The first category of instruments is based upon the model of option contracts. The first application of options is bay' al-urbun, urbun refers to a sale in which the buyer deposits earnest money with the seller as a part payment of the price in advance but agrees that if he fails to ratify the contract he will forfeit the deposit money which the seller can keep. A simulation can be drawn between al-urbun to a call option in the sense that the seller does not return the premium or advance payment to the buyer. The accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 2008) in standard 1, trading in currencies, has pointed out the impermissibility of options in Shari'ah but has instead approved the use of *Urbun.* Moreover, the Shari'ah Advisory Council (SAC) of Malaysia concluded that the concept of *bay` urbun* is permissible and can be developed as an instrument in the Malaysian Islamic capital market.

The pricing of Bay' Al-urbun will be defined by the famous formula of Black & Scholes. Many similitude can be spotted between *bay' Al-urbun* and a call option. However, there is two main differences between the two instruments:

- The deposit in the case of *Bay' Al-urbun* is a part of the global price in the opposite of the premium paid which is a non-refundable payment;
- During the transaction, the bank should detain the underlying assets as Shari'ah forbids intangible financial transactions.

The second application of options is Istijrar contracts involving two parties, a buyer and a financial institution. The contract has embedded options that could be triggered in the underlying asset's price exceed certain bounds. The contract is complicated as it constitutes a combination of options, average prices and Murabahah or cots plus financing. A typical *Istijrar* transaction could be as follows; a company seeking short term working capital to finance the purchase of a commodity approaches a bank. The bank purchases the commodity at the current price (P_o), and resells it to the company for payment to be made at a mutually agreed upon date in the future. The price at which settlement occurs on maturity is contingent on the underlying asset's price movement from t_0 to t_n. Where t_0 is the day the contract was initiated and t_n is the n^{th} day which would be the maturity day. Unlike a typical Murabahah contracts where $P^* = P_0 (1+r)$ with P^* is the price on maturity and r is the profit rates, the P^* in *Istijrar* contract could be P^* cited above or an average price P of the commodity between P_0 and P_n. Consequently, the exercise price of the option is based on the expectation of both counterparties on the fluctuation of the price of the assets during the period of the contract. It presents a concrete illustration of risk-sharing based instruments where it is no longer a zero-sum game as both parties get benefits from the contract.

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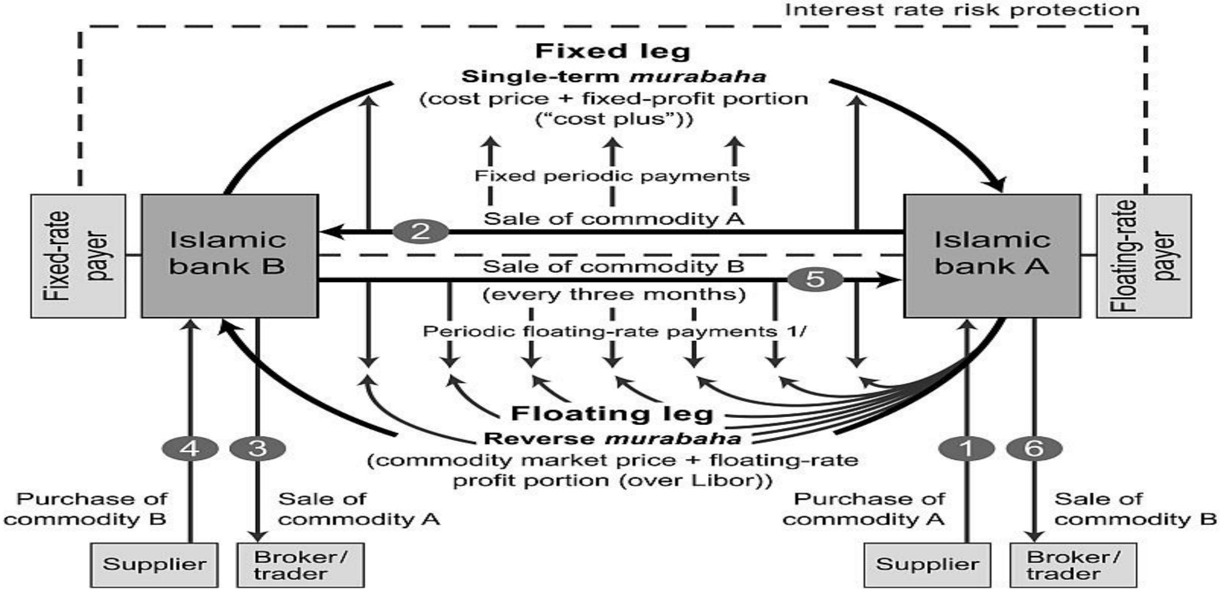
[5] "Learning Curve – Derivatives in Islamic Finance", Derivatives Week, 5 May 2008.

The next hedging instrument that we chose to present in spite of its complexity is the profit rate swap contract. The Profit Rate Swap seeks to achieve Sharia-compliance by using reciprocal *murabahah* transactions to secure the cash-flows over the period of the contract. In this scheme, the parties enter into *murabahah* contracts to sell an assets (often London Metal Exchange traded metals) to each other for immediate delivery but on deferred payment terms in order to generate fixed payments. Then, the parties enter into a series of corresponding reverse *murabahah* to generate the floating leg payments. The illustration below explains with more insight the cited mechanism underlying the profit rate swaps:

Fig.1: General Structure of Profit Rate SWAPs



Source: Jobst (2009).

The same mechanism can be conducted to the currency swaps as applied and exchanged in Malaysia. However, there are some striking shari'ah issues concerning these types of structures mainly reverse murabahah contracts that presents a manipulated way to get cash. Oppositely, shari'ah forbids pure financial transaction despite the justification made here that there is actually a real exchange of products. Nevertheless, this exchange rarely takes a full juridical form and consists of paper transaction and the forbidden element of bay' al-'ina. Consequently, efforts are still needed to develop and ameliorate these hedging instruments to reach an acceptable consensus upon them.

III. CRUDE PLAM OIL FUTURES:

a. Definitions:

The only tradable Future contract with shari'ah compliance is Crude Palm Oil Future (CPOF) in Malaysia. In spite of the existence of many shari'ah rulings against the use of futures[6], the

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[6] The ruling of the Islamic Fiqh Academy of the Muslim World League IFA-MWA in 1985 (as cited in Al-amine, 2008: 14). The IFA-OIC in 1992 resolved for relatively the same reasons advanced by the IFA-MWL that commodity future contract are prohibited as both payment and delivery take place in the future. The AAOIFI issued a ruling in 2004 that categorically prohibit commodity future contract. Indeed, the

Shari'ah Advisory Council (SAC) in Malaysia in its eleventh meeting, on November 26, 1997, resolved that the Crude Palm Oil Futures (CPOF) is in accordance with shari'ah principles. The SAC ruled that CPOF are free from elements of *Gharar* and *Maysir*; and even of such elements exist, the trading regulations have overcome them (Securities Commission, 2006: 75).

The issues on Futures can be presented in the opinion of Mufti Taqi Usmani writing that modern day Futures contracts are invalid for two reasons. *«Firstly, it is a well-recognized principle of the Shariah that sale or purchase cannot be affected for a future date. Therefore, all forward and futures transactions are invalid in Shariah. Secondly, because in most of the futures transactions, delivery of the commodities or their possession is not intended. In most cases, the transactions end up with the settlement of difference of prices only, which is not allowed in the Shariah".*

Consequently, we can say that there three main shari'ah issues that impedes a general consensus and a wild use for them among Muslim countries. It is worth to note that these issues surround most of hedging instruments which explains the hesitation on their adoption. We can sum up them in three points:

- The sale of a non-existent assets;
- The sale of debts;
- The deferment of both counter-values.

Here below we shall explain with more detail each points along with the main shari'ah opinions about them.

b. The sale of a non-existent asset:

In our case, the asset in question is the CPO and it can be extended to any other hedging operation. The sale of non-existent asset in Islamic law is expressed as *bay' al-ma'dum*. It refers to transactions involving non-existing element which normally renders them void. According to the SAC, the prohibition of *bay' al-ma'dum* is due to the element of uncertainty in handing over the sold goods and not due to the non-existence of the object at the time when the contract is being made. The justification given by the SAC is based on the *istisna'* and *salam* contracts the subject matter of istisna' is definitely non-existent at the time of the contract while the subject matter of salam may be non-existent (Securities Commission, 2006). The element of *gharar* which is the subject matter behind the prohibition of *bay' al-ma'dum* is neutralized is the case of future market by the clearing house which ensures the delivery and settlement of crude palm oil futures contracts. Even if there is gharar, it is eliminated by the crude palm oil futures contract trading regulation which provides for surveillance and insurance against any cheating (Securities Commission, 2006). This opinion is shared by some shari'ah scholars like Azzam, al Khatib and Abd al Qadir who affirms that registration and clearance procedures, as well as the guarantee functions of the clearinghouse, are precise and that trading futures are conducted by trained professionals in a highly

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organization confirmed that futures are prohibited neither forming them nor trading them. The basis for this ruling if the verse in *surat Al-nisa'* (4:29).

centralized and controlled market. Thus, the conclusion is drawn that futures contracts are valid from the Shari'ah perspective (Kamali, 1996).

In addition to that, the main argument advanced to prohibit Futures based on the issue of *bay' al-ma'dum* is of the Prophet pbuh "sell not what is not with you". However, Al Khatib records the view that this Hadith conveys moral guidance (irshad) rather than a prohibition per se.[7] Eventually, this prohibition seeks to prevent *gharar* in sales that consists of uncertainty over delivery.[8]Furthermore, Ibn Rushd confirmed this and stated, "There is no disagreement in the Maliki School that only food grains (mainly wheat and barley) cannot be sold prior to *qabd*."

Consequently, it is obvious that by neutralizing *gharar* on Future transaction through tight regulation and an efficient clearinghouse will pave the way to lift the prohibition on the sale of a non-existent CPO.

c. The Sale of Debt:

Bay' al-dayn (sale of debt) basically envisaged sale over an unpaid debt involving either two, or in some cases, three parties. It is usually formed by a trader who enters the market either as buyer or seller without any material exchange of values.[9] Shaikh Mahmud Ahmad notes that Imam Malik explains the meaning of such bay' in these words:

"A person sells cloth or some other goods on the promise of payment by the buyer after one month. A month passes and the buyer, being unable to make the payment, asks the seller to sell his debt of one month for a debt of two months, and raise the quantum of debt. This is the sale of debt in exchange for another debt." (Obaidullah, 1999)

Regarding Future markets, since the parties involved are able to offset their transaction by selling the "debts" to other parties before the delivery date, the prohibition towards futures contract has to be applied. The disagreement is that this feature amounts to sale of a debt and is, thus, not allowed by Sha'riah (Obaidullah, 2001).

The reason of its prohibition was over uncertainty in its repayment. Also, the prohibition is justified over ambiguity in its settlement as this operation can be conducted for the purpose of delaying a payment of a bad debt or one in which the debtor merely wanted a further impediment due to his incapability to pay on time.

However, the situation is very different in the futures market now where all transactions are concluded over guaranteed debts.

Moreover, the prominent scholar Ibn Qayyim affirms when examination the source evidence on *bay' al-dayn* that "there is neither explicit nor implicit text in the *Shari'ah* on its prohibition. On the contrary the principles of *Shari'ah* indicate its permissibility."[10] The Maliki have also advocated the legality of certain types of bay al dayn prior to delivery and qabd when the debts involved within do not appear from the exchange of food goods and useable goods, and the transaction is also free of gharar.[11]As a clear definition of bay' al-dayn is not reached among scholars, the only evidence from the Sunnah on this matter comes from Musa Ibn 'Ubayd reported from Abdellah Ibn Omar that the Prophete pbuh prohibited *bay' al-kali bi al-kali* and its precise meaning is also subject to doubt.

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[7] Al Khatib, *al Siyasah al Maliyah*, 176, note 29.

[8] Al Khattabi, *Ma'alim al Sunan*, 5:143, note 29; see also al Qaradawi, *Bay' al Murabahah*, 56, note 22.

[9] Obiyathulla Ismath Bacha, Derivatives in Islamic finance

[10] Ibn Qayyim al-Jawziyya, *I[lam al-Muwaqqiin*, Beirut: Dar al-Kutub al-Ilmiyya, 1991, Vol. II, p. 9.

Consequently, bay al-dayn, which is involved in futures, is in the nature of the completion of outstanding obligations and of debt repayment by the debtor. According to Kamal Hashim this is clearly permissible and conforms to the Qur'an norm on the fulfillment of contracts[12].

d. Deferment of Both Counter-values:

Rafiq al-Misri[13] has argued that there is no extra *gharar* in deferring both counter values compared to the deferment of one of them only. If one of the counter values has been delivered while the other is deferred to a future date, or when both are so deferred, the level of risk would be the same and no additional *gharar* is likely when both are deferred. Suppose that the buyer in a deferred payment sale receives the commodity but defers the payment of price, it is possible that the price fluctuates during the interval, and one of the parties suffers the consequences. It could be the seller if the spot price goes up or the buyer if it goes down. It should be noted that in the case of *Salam* sale, the risk will be about the same even if both counter values were deferred. Of course, in the case of deferment of one counter value one of the parties to the contract will benefit from the receipt of the commodity.. If both counter values were deferred, both parties will share the risk and the expected *gharar* would be about the same. Thus there is no ground for the claim that *gharar* would be greater if both counter values are deferred.

CONCLUSION

The debate on hedging instruments seems to be directed toward insistence of shari'ah scholars on their disadvantages which is motivated by the practices of excessive speculation of western markets. However, we fall to ignore that by putting aside risk management tools we are hurting the competitiveness of millions of businesses all over the Muslim worlds. Suppose the case where Colombian CPO producers have suitable contracts to lock on their prices in comparison to Malaysian producers who will be exposed to the fluctuations of the markets. Eventually, the competitiveness of Malaysia would be badly impacted which can lead to business failures and negative social consequences. In addition to that, why should a simple exporter bear bad monetary decisions of foreign countries if he/she does not has suitable hedging instruments to protect his/her business?

Protection of one property is an essential pillar of *Maqasid al-shari'ah*, thus hedging would be for no harm to Muslim community. Furthermore, the nature of the current economic trends and business pushes to more effort in Islamic Risk Management to offset the extremely volatile market. Also, the basic norm of *Shari'ah* is prohibition (*al-hazar*) in the field of *'ibadat* (worship matters) and it is permissibility (*ibahah*) in *mu'amalat* and commercial transactions. Nothing in this latter area must be declared forbidden without decisive and indisputable evidence. Consequently, in the light of the argument advanced, there is no decisive evidence on the prohibition of hedging; it is then permissible in *Shari'ah*. A transaction is valid from the *Shari'ah* perspective when it does not include *riba*, and it does not partake in excessive *gharar*. The instruments advance above would fall under the basic principle of permissibility, with the condition to undertake in a continuous process to establish vigilance and develop more refined safeguards against abuse, excessive speculation, and *gharar*.

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[11] Mohammad Hashim Kemali, Commodity futures: an Islamic legal analysis. Thunderbird International Business Review 49, no. 3, 2007, pp. 309-339.

[12] Mohammad Hashim Kemali, Islamic Commercial Law: An Analysis of Futures and Options, Cambridge: the Islamic Texts Society, 2000.

[13] Rafiq al-Misri, *al-Jami[fi Usul al-Riba*, Damascus: Dar al-Qalam, 1991, p. 339f, as quoted in al-Amine, "Futures Trading", p. 79.

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